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Government Steps Up Audits of Tax-Exempt and Governmental Employer Plans
by Jeffery Mandell

As one of the appointed representatives who meets regularly with senior Internal Revenue Service and Department of Labor officials regarding ERISA (the TE/GE Liaison Group – "TE/GE" stands for Tax-Exempt and Government Entities), I share some comments from our most recent meeting.

A. Greater Government Interest

It is no secret that both the IRS and DOL have significantly invigorated their interest in retirement plans maintained by governmental, not-for-profit and other tax-exempt employers. These plans include 401(a), 403(b), 457(b) and 457(f) plans, deferred compensation arrangements and employment contracts. The Federal government's heightened interest in these plans and these employers is most evident from:

- several sets of regulations they have issued the last few years,
- the development of a 403(b) prototype plan,
- outreach to these employers to educate them and try to encourage voluntary compliance,
- an amnesty program, and
- more focused and effective enforcement (that is, audits or examinations).

B. Widespread Failures

The government has found what ERISA lawyers have known for some time: noncompliance is severe and rampant among governmental and tax-exempt employers (notably including school districts), thus risking numerous adverse consequences.

Plan failures cover the entire waterfront, including for example:

- missing plan documents or current plan documents,
- impermissibly excluding employees from plans,
- failing or not performing required IRS tests,
- making mistakes with or overlooking the unique requirements of the various catch-up opportunities,
- employers that are maintaining certain types of plans that are not eligible to maintain those plans (for example, tax-exempt employers maintaining plans that such employers have mistakenly adopted instead of what was intended – and vice versa, where governments are adopting types of plans they are not allowed to adopt),
- uncertainty as to whether an employer is or is not a government employer (this arises when a government and a sister non-government join hands), and
- failing to make the requisite filing with the Department of Labor for some plans.

C. Employment Agreements

The IRS is also examining employment agreements of these employers. They have found that often the employer and employee are not aware that employment agreements are sometimes subject to these plan rules, including Section 409A.

D. Prior Inattention Gives Way to IRS and DOL Enforcement

For historical reasons, tax-exempt and governmental employers (unlike for-profit companies) largely have not reached out to ERISA attorneys nor known of the need to focus on legal requirements. That has been left to the providers for these plans. Now that the government has decided to do something about the widespread noncompliance in this marketplace, the terrain has changed.

For example, the Internal Revenue Service is sending letters to tax-exempt sponsors of 457 plans (both 457(b) and 457(f)), requesting information about the employer, plan and plan's compliance. Although a "compliance check" is voluntary, the IRS can (and they state they will) open an examination if the plan sponsor does not participate.

Compliance checks, arming the government with information to more effectively examine plans, typically precede more global and more robust audits. This has occurred just recently in connection with Section 401(k) plans.

E. Unique Rules

The rules that apply to taxable employers for 401(k) and other qualified plans, and for deferred compensation plans, are different from the rules that apply to tax-exempt employer plans (such as 457(b) plans, 457(f) plans, 403(b) plans and 401(a) qualified plans). Furthermore, the rules applicable to governmental employers and non-governmental tax-exempt employers differ in very key respects.

Complicating the situation is that the emerging IRC Section 409A rules for deferred compensation plans also apply to some of these plans for tax-exempt employers, yet there is a material twist applicable just to tax-exempt employers under Section 457(f).

These unique rules do not allow plans of these employers to be designed like plans for taxable employers in key respects.

F. Plan Remedies

The fix-it programs the Internal Revenue Service and Department of Labor offer (most notably "EPCRS," the Employee Plans Compliance Resolution System) apply differently to non tax-exempt versus tax-exempt and governmental employers. For example, the Federal government does not bless any corrective action for a tax-exempt non-governmental employer that maintains a retirement plan that fails the seemingly straightforward yet deceptive rules under Section 457(b). Instead, all of the money is includible in the participants' taxable income for their open tax years.

G. Conclusion

Employers and others in the retirement plan business often confuse or do not recognize the legal distinctions among different types of employers when applied to various retirement plans, employment agreements and deferred compensation arrangements. This causes tax-exempt and governmental plans to risk losing their status as proper plans. The DOL and IRS ramifications from noncompliance are significant.

Repairing a plan before a compliance check or audit very significantly improves the likelihood of a better outcome, including under EPCRS. Responses to a compliance check or examination should be carefully considered and managed.

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